No. 82-1369

In the Supreme Court of the United States

OCTOBER TERM, 1982

WESTERN COAL TRAFFIC LEAGUE, ET AL., PETITIONERS

v.

UNITED STATES OF AMERICA, ET AL.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

BRIEF FOR THE FEDERAL RESPONDENTS IN OPPOSITION

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QUESTIONS PRESENTED

1. Whether the Interstate Commerce Commission's adoption, as the standard for railroad revenue adequacy, of a rate of return on net investment equal to the current cost of capital was consistent with 49 U.S.C. 10704(a)(2) and constituted a reasonable exercise of discretion.

2. Whether the Commission's definitions of cost of capital and net investment base were arbitrary and capricious.

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OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 1a-35a) is reported at 691 F.2d 1104. The decision of the Interstate Commerce Commission (Pet. App. 1b-24b) is reported at 364 I.C.C. 803.

JURISDICTION

The judgment of the court of appeals was entered on October 19, 1982 (Pet. App. 1d-2d), and petitions for rehearing were denied on November 15, 1982

(Pet. App. 1c-2c). The petition for a writ of certiorari was filed on February 14, 1983. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

1. Congress enacted the Railroad Revitalization and Regulatory Reform Act of 1976, Pub. L. No. 94-210, 90 Stat. 31 (the "4R Act"), in the face of a sea of bankruptcies involving most railroads serving the northeastern United States. Intervention by the Interstate Commerce Commission into railroad rate-making was perceived as a major contributor to the carriers' weakened financial position, and Congress sought to restore stability by reducing regulatory restraints on rail carrier pricing decisions. See S. Rep. No. 94-595, 94th Cong., 2d Sess. 134 (1976). Thus, the 4R Act substantially limited the power of the Commission to find rates unreasonably high or low, and restricted the Commission's power to suspend rate changes. 4R Act, Section 202(b) and (e), 90 Stat. 35, 36-38.

The 4R Act also directed the Commission to develop and promulgate reasonable standards for the establishment of adequate railroad revenue levels, and then to make "an adequate and continuing effort to assist those [rail] carriers in attaining [the] revenue levels prescribed * * *." 4R Act, Section 205, 49 U.S.C. (Supp. IV) 10704(a)(2) * * *.[1] The Act

[1] The provision enacted by the 4R Act was originally codified at 49 U.S.C. 15a(4). That provision was restated without substantive change as 49 U.S.C. (Supp. IV) 10704(a)(2) by the Act of Oct. 17, 1978, Pub. L. No. 95-473, 92 Stat. 1337. See H.R. Rep. No. 95-1395, 95th Cong., 2d Sess. 70, 72 (1978). The excerpt quoted above is from the restated provision as it appears in 49 U.S.C. (Supp. IV) 10704(a)(2).

carefully specified that the revenue levels established by the Commission as adequate must be sufficient to "support prudent capital outlays, assure the repayment of a reasonable level of debt, permit the raising of needed equity capital, * * * cover the effects of inflation * * * [and] attract and retain capital in amounts adequate to provide a sound transportation system in the United States." *Ibid.* Congress did not, however, give carriers whose revenues were determined to be inadequate any regulatory freedoms unavailable to "revenue adequate" carriers, or specify how the Commission was to use its revenue adequacy findings in individual rate proceedings.

Pursuant to the 4R Act, the Commission began an extensive rulemaking proceeding to devise standards of revenue adequacy. *Establishment of Adequate Railroad Revenue Levels*, 358 I.C.C. 844, modified, 359 I.C.C. 270 (1978) (*Ex Parte No. 338*). Upon promulgation of generic standards, the Commission conducted a proceeding to make revenue adequacy determinations for individual railroads. See *Adequacy of Railroad Revenue*, 361 I.C.C. 79 (1978), and 362 I.C.C. 198 (1979), petition for reopening denied, 362 I.C.C. 794 (1980) (*Ex Parte No. 353*).

Rather than adopting a single standard of revenue adequacy in these proceedings, the Commission defined a range between a minimum and a maximum standard. The minimum standard was determined by using the "flow of funds" approach, advocated by shipper groups (including several of the petitioners herein). This method was designed to measure the revenues required to (1) pay all operating expenses and contractual debt obligations, and (2) provide enough equity capital from retained earnings to permit financing of all necessary future investments at the current cost of capital for debt and equity. *Ex*

Parte No. 338, *supra*, 358 I.C.C. at 859-860; *Ex Parte No. 353*, *supra*, 362 I.C.C. at 204, 227-242. The maximum standard for revenue adequacy was defined as the "fair return level"—*i.e.*, a rate of return equal to the cost of capital multiplied by the net investment base. *Ex Parte No. 338*, *supra*, 358 I.C.C. at 896; 359 I.C.C. at 273; *Ex Parte No. 353*, *supra*, 362 I.C.C. at 223-224. In addition, the Commission proposed to give weight to a number of financial indicators in determining the revenue adequacy of individual carriers; where a carrier's revenues fell within the range, these indicators would be used in making a judgment regarding revenue adequacy. 358 I.C.C. at 858-860.[2]

The railroad industry continued to struggle financially despite the 4R Act reforms, prompting Congress to enact the Staggers Rail Act of 1980,[3] Pub. L. No. 96-448, 94 Stat. 1895 ("Staggers Act"). The

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[2] Using these standards, the Commission found 13 carriers with rates of return ranging from 4.02 to 11.70 percent to be revenue adequate, and 23 carriers with rates of return ranging from -40. to 4.65% to be revenue inadequate. 362 I.C.C. at 297-341.

[3] For example, during this period, two major midwestern rail carriers—the Chicago, Rock Island & Pacific Railroad and the Chicago, Milwaukee, St. Paul and Pacific Railroad—not only declared bankruptcy, but ceased providing service over the major parts of their systems, forcing congressional intervention. See Rock Island Transition and Employee Assistance Act, Pub. L. No. 96-254, 94 Stat. 399; Milwaukee Railroad Restructuring Act, Pub. L. No. 96-101, 93 Stat. 736. Two other major carriers—Consolidated Rail Corporation and the Delaware & Hudson Railroad—required major government subsidies. U.S. Railway Ass'n, *Conrail at the Crossroads: The Future of Rail Service in the Northeast* 2, 39 (1981). See also the Commission's initial revenue adequacy determinations in *Ex Parte No. 353*, 362 I.C.C. at 257.

express purpose of the new legislation was "to provide for the restoration, maintenance, and improvement of the physical facilities and financial stability of the rail system of the United States." Section 3, 94 Stat. 1897, 49 U.S.C. (Supp. IV) 10101a, note. This financial and physical improvement was to be accomplished primarily through further limiting of federal regulation of railroad ratemaking and through encouraging the earnings levels necessary to attract needed capital. H.R. Rep. No. 96-1430, 96th Cong., 2d Sess. 79-80 (1980).

In the Staggers Act, the Commission once more was directed to complete a proceeding—this time within 180 days—to establish standards of revenue adequacy and to determine which railroads were meeting those standards. Section 205(b)(2), 49 U.S.C. (Supp. IV) 10704(a)(3) and (4). Additional such proceedings were to be conducted in subsequent years. The Staggers Act also directed the Commission to consider revenue adequacy in any proceeding involving the reasonableness of a railroad rate. Section 201(a), 49 U.S.C. (Supp. IV) 10701a (a)(3). Only railroads not earning adequate revenues would have the right, after 1984, to increase rates by 4% per year without those increases being subject to suspension (Section 203(a), 49 U.S.C. (Supp. IV) 10707a(d)(3) and (e)), and only railroads not earning adequate revenues would have the right to impose surcharges on all traffic moving under joint rates (Section 217(a)(1), 49 U.S.C. (Supp. IV) 10705a(a) and (b)). Under this statutory scheme, then, a finding of revenue adequacy would narrow the ratemaking flexibility of the carrier involved.

2. a. Faced with these congressional directives, the Commission instituted the proceeding that is the subject of the instant petition. *Ex Parte No. 393*,

Standards for Railroad Revenue Adequacy, 45 Fed. Reg. 80150-80155 (1980). The Commission proposed that, in light of the emphasis of the Staggers Act on revenue adequacy, the then-existing standards should be replaced. Under the proposed standards, revenues would be deemed adequate if a railroad earned a rate of return on investment equal to the current cost of capital, and if the railroad achieved certain financial ratios consistent with a sound financial condition. The Commission proposed to withdraw the "funds-flow" standard. 45 Fed. Reg. 80151-80152 (1980).

After consideration of voluminous comments filed by railroad and shipper interests, the Commission promulgated its current revenue adequacy standards. *Standards for Railroad Revenue Adequacy*, 364 I.C.C. 803 (1981) (Pet. App. 1b-24b) ("*Ex Parte No. 393*"). The Commission found (Pet. App. 7b-8b) that the most appropriate standard for determining if a railroad has adequate revenues is whether it receives a rate of return equal to the current cost of capital. This rate of return was deemed the minimum rate of return that would allow railroads to obtain investment funds, because, in the Commission's judgment, "investments earning less than the cost of capital will, in general, not maintain existing funding nor obtain new funding" (*id.* at 8b).

The Commission also stressed that a rate of return equal to the current cost of capital would satisfy all of the statutory criteria, because it would give carriers a " 'flow of net income sufficient to support prudent capital outlays, assure the repayment of a reasonable level of debt, permit the raising of needed equity capital, cover the effect of inflation' and otherwise meet the requirements of the statute" (Pet.

App. 8b, quoting 49 U.S.C. (Supp. IV) 10704(a)(2)(A)).

b. Having adopted this standard for determining revenue adequacy, the Commission next defined the relevant cost of capital as a weighted average of the current cost of debt and equity. The Commission rejected the shippers' contentions that the embedded cost of debt, reflecting the historical cost of prior investment, should be used. The Commission explained, repeating the analysis provided in the Notice of Proposed Rulemaking (Pet. App. 13b):

> A sound transportation system should return the cost of capital to investors and reflect that cost of capital in prices paid by users. These are forward-looking concepts. The year and the rate at which past debt was raised are not ~~revelant~~ RELEVANT for these purposes. The more relevant consideration is the cost to the railroad of raising (or not losing) capital for current and future investment.

The Commission did not exclude unused and non-useful assets from the initial calculation of the net investment base, finding that to do so would be impractical in the 180-day period available to complete the initial proceeding and that only minimal distortions would result in any event (Pet. App. 10b). The Commission also determined that reserves for deferred taxes that would have been due had the railroads not used the accelerated rather than straight-line depreciation method for tax purposes should not be subtracted from the investment base.

3. The court of appeals affirmed the Commission's decision in all respects.[4] The court held that the "over-

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[4] A cross-petition filed by several railroads, objecting to the Commission's statement that it would, in a future pro-

all policy pursued by the agency [in adopting a single rate-of-return standard] is entirely consistent with Congressional directives," and that the "[r]easons for departure from the ICC's prior position with respect to use of financial ratios and flow of funds analysis, and for refraining from incorporating productivity standards * * *, have been carefully explained" (Pet. App. 26a). The court further concluded that the agency's use of the current (rather than embedded) cost of debt was consistent with the statute (*id.* at 28a-29a), and that the agency had adequately explained the inclusion of both unused and unuseful assets and the reserve for deferred taxes in the investment base (*id.* at 31a, 33a).

ARGUMENT

The court of appeals correctly determined that the Commission's revenue adequacy standards are consistent with the statutory scheme and supported by the Commission's analysis. The decision conflicts with no decision of this Court or of any court of appeals, and does not warrant further review.

1. Petitioners urge (Pet. 9-13) that the revenue adequacy standards adopted in *Ex Parte No. 393* raise important questions concerning the Commission's regulation of rail rates, because, in petitioners' view, the standards deprive captive rail shippers of the maximum rate protections provided in the Interstate Commerce Act. This argument confuses the distinct issues of defining revenue adequacy, on the one hand, and utilizing the concept of revenue adequacy in ratemaking decisions, on the other. Only the Com-

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ceeding, consider excluding "unused and nonuseful assets" from the investment base, was denied as not ripe for judicial review (Pet. App. 33a-34a).

mission's definition of revenue adequacy is at issue in this case.

The purpose of both the 4R Act and the Staggers Act was to help rehabilitate and maintain the physical facilities of the railroad industry and to restore its financial integrity. 4R Act, Section 101(a), Pub. L. No. 94-210, 90 Stat. 33; Staggers Act, Section 3, Pub. L. No. 96-448, 94 Stat. 1897. Thus, because revenue adequacy findings must be considered in rate proceedings and can limit a carrier's access to several Staggers Act reforms, revenue adequacy must be carefully defined to ensure that no carrier is labeled revenue adequate unless its revenues are "adequate" for the purposes Congress sought to achieve: the obtaining of long-term financing for the rehabilitation and maintenance of that carrier's physical plant.

Contrary to petitioners' contention, however, the Commission's definition of revenue adequacy does not have the effect of "depriving captive rail shippers of the maximum rate protections which Congress intended them to have" (Pet. 9). Individual rates, or methods that may be used to determine individual rates, are not at issue here. Although the Commission is required to "consider" revenue adequacy in individual rate cases (49 U.S.C. (Supp. IV) 10701a (b)(3)), the Commission's decision in this case does not determine or even discuss what form that consideration might take. Accordingly, the decision below does not preclude shippers from seeking relief from unreasonable rates charged by carriers even if those carriers are determined to be revenue inadequate. Indeed, both the Commission and the court of appeals stressed that "a revenue adequacy determination is no guarantee that any carrier will attain any level of revenue" (Pet. App. 6b, 7b, 27a).

Petitioners apparently believe that the Commission has given undue weight to carrier revenue needs in the concededly "few" individual rate cases decided after the Commission rendered the decision at issue here. They point (Pet. 11) to several individual rate cases in which revenue inadequacy was considered.[5] Petitioners' argument regarding the methods used in individual rate cases has no relevance here. None of these cases is now before the Court, and petitioners' objections with respect to them may be raised in actions seeking judicial review in those cases. This case, as we have said, concerns only the Commission's definition of revenue adequacy.[6]

Petitioners also contend (Pet. 13) that the standard adopted by the Commission must be erroneous because it results in a finding of revenue inadequacy for many railroads and, hence, no "meaningful distinction" is made between financially strong and weak railroads.

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[5] All but one of these cases involved carriers whose revenues were inadequate under both the new standards adopted by the Commission in the instant proceedings and the old standards. The exception is the *Chesapeake & Ohio Ry.*, Docket No. 38793, petition for review of a decision of the Public Service Comm'n of West Virginia (served Mar. 18, 1982), appeal docketed, No. 82-3122 (3d Cir.), *Wheeling Pittsburgh Steel Co.* v. *ICC*.

[6] Similarly, the Commission's *proposed* guidelines for taking revenue adequacy into account in ratemaking proceedings, set forth in a notice in *Ex Parte No. 347 (Sub-No. 1)*, *Coal Rate Guidelines—Nationwide* (served Feb. 24, 1983), discussed in the Brief Amicus Curiae filed by the Consumer Owned Power Coalition (at 18-22), may be contested in an action challenging those guidelines if they are finally adopted by the Commission or in an action contesting individual rates determined by reference to the proposed or final guidelines. Those guidelines do not furnish a basis for reviewing the revenue adequacy standards themselves in this case.

The purpose of the Staggers Act, however, was not to require the Commission to determine which carriers have more adequate or less adequate revenues on a relative basis. Rather, it required the Commission to define revenue adequacy at levels sufficient to "attract and retain capital in amounts adequate to provide a sound transportation system." 49 U.S.C. (Supp. IV) 10704(a)(2)(B). Further, Congress made explicit findings in the Staggers Act that earnings of the railroad industry as a whole were "insufficient to generate funds for necessary capital improvements" and that "by 1985, there will be a capital shortfall within the railroad industry of between $16,000,000,000 and $20,000,000,000." Staggers Act, Section 2, 94 Stat. 1896. Given these findings, Congress could not have anticipated that the Commission would find large numbers of carriers to be revenue adequate. See Pet. App. 15b-16b.[7]

2. The court of appeals correctly rejected petitioners' contention (Pet. 14-18) that 49 U.S.C. (Supp. IV) 10704(a)(2) "expressly precluded" the Commission from adopting return on investment as the sole measure of revenue adequacy. As its terms make clear, 49 U.S.C. (Supp. IV) 10704(a)(2) does not require the Commission either to adopt or to avoid any particular method for determining revenue adequacy. Rather, the statute lists several performance tests for

[7] Petitioners cite (Pet. 13) the Burlington Northern Railroad (BN) as an example of a strong railroad that should be considered revenue adequate, because it had the resources recently to acquire control of El Paso Natural Gas Company. Contrary to petitioners' contention, however, BN's decision to invest internally generated funds outside the rail industry in fact does not speak well for the profitability of BN's rail operations. Moreover, BN was considered revenue inadequate even under the old standards that petitioners now seek to have reinstated. See *Ex Parte No. 353, supra,* 362 I.C.C. at 303.

carrier revenue adequacy, and requires the Commission to design standards that would enable railroads to satisfy those tests. Thus, Section 10704(a) provides:

> The Commission shall maintain and revise as necessary standards and procedures for establishing revenue levels for rail carriers * * * that are adequate, under honest, economical, and efficient management, to cover total operating expenses, including depreciation and obsolescence, plus a reasonable and economic profit or return (or both) on capital employed in the business.

Further, the revenue levels established by the Commission must—

> (A) provide a flow of net income plus depreciation adequate to support prudent capital outlays, assure the repayment of a reasonable level of debt, permit the raising of needed equity capital, and cover the effects of inflation; and (B) attract and retain capital in amounts adequate to provide a sound transportation system in the United States.

The Commission found that a rate of return on investment equal to the current cost of capital would satisfy all of these performance criteria (Pet. App. 7b-9b). The Commission credited the testimony of a witness in the proceedings, Professor Baumol, that any decision which precluded a compensatory return on a railroad's cost of capital would result in disinvestment from the railroad industry, because investors would choose to invest their funds elsewhere at a higher rate of return (Pet. App. 7b-8b). Such disinvestment in turn would lead to deterioration of plant and equipment, avoidance of replacement of equipment, neglect of opportunities for moderniza-

tion, and withdrawal of railroad services valued by customers. In contrast, the Commission concluded that the rate-of-return standard would prevent these results, and thus was entirely consistent with congressional directives.[8]

Petitioners contend (Pet. 17), however, that the Commission did not explain its departure from its prior position, expressed in *Ex Parte No. 338*, that it would look to factors beyond the rate of return in determining revenue adequacy. See *Ex Parte No. 338*, *supra*, 358 I.C.C. at 858-860; *Ex Parte No. 353*, *supra*, 362 I.C.C. at 216. This contention is without

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[8] Contrary to petitioners' contention (Pet. 16-17), the opinion of the District of Columbia Circuit in *San Antonio* v. *United States*, 631 F.2d 831, 850 n.104 (D.C. Cir. 1980), modified, 655 F.2d 1341 (1981), rev'd on other grounds *sub nom. Burlington Northern, Inc.* v. *United States*, No. 81-1008 (Dec. 13, 1982), supports rather than undermines the Commission's and court of appeals' decision. The court there stated that although 49 U.S.C. (Supp. IV) 10704(a)(2) reveals that revenue levels must provide net income adequate to support prudent capital outlays, assure the repayment of a reasonable level of debt, and permit the raising of needed equity capital, "that language specifies not at all the exact methodology that the Commission shall use in accomplishing the mandate." 631 F.2d at 850 n.104. The court likewise rejected the city's reliance upon the same Senate Report relied upon by petitioners herein (Pet. 15, quoting S. Rep. No. 94-499, 94th Cong., 2d Sess. 51-52 (1975)); it noted that although the Report indicates that the Commission should not focus solely on rate-of-return analysis and should adopt a prospective view of revenue needs, the Report does not prescribe the specific standards by which to determine the adequacy of revenue levels. 631 F.2d at 850 n.104. Here, the Commission did not focus solely on rate of return. It explicitly considered the other statutory criteria of adequacy and determined that a rate-of-return standard would assure sufficient income to meet those criteria (Pet. App. 86-96).

merit. The Commission explained that in *Ex Parte No. 338* and *Ex Parte No. 353*, it had established a range of revenue adequacy, with a high value to be determined by looking to the cost of capital and a low value to be determined by using a flow of funds model. The Commission stated that flow of funds determinations "represent *minimum* target levels to be achieved" and "are appropriate as indicators only of the short-term viability of railroads" (Pet. App. 6b (emphasis added)). These indicators, the Commission explained, were "never intended to define a long-term level of adequate revenue" (*id.* at 5b), and "are especially inappropriate as measures to limit rail pricing flexibility which is one of the roles the [Staggers] Rail Act accords revenue adequacy findings" (*id.* at 6b). The Commission continued (*ibid.*):

> If we adopted the Ex Parte No. 353 minimum or short-term standard for use here, we would likely in the next few years find ourselves denying a railroad the pricing flexibility necessary to obtain long-term revenue adequacy simply because that railroad was making some progress toward achieving that goal. In short, we would be assigning the railroads the Sisyphean task of working toward revenue adequacy, and every time it came close robbing it of the very means it had used to get there. We do not believe this is desirable nor do we believe it was intended by Congress. Thus, our adoption of a rate of return standard is not a radical departure from our previous standards. Ex Parte No. 353 clearly accepted rate of return as a proper standard for ascertaining if a railroad has actually earned adequate revenues. In adopting such a standard here, we are only adapting our earlier findings to the mandate and policy of the [Staggers] Rail Act.

Finally, the Commission stressed that a finding of revenue inadequacy does not give a railroad license to set rates at unreasonable levels, because "revenue need is not the only factor to be considered when the reasonableness of a rate is determined" (*id.* at 7b). As a result, "the computation of an adequate revenue level for the carrier does not represent a guarantee that the carrier will attain such a revenue level" (*ibid.*).

The court of appeals held that the "[r]easons for departure from the ICC's prior position with respect to use of financial ratios and flow of funds analysis * * * have been carefully explained" (Pet. App. 26a).[9] The Commission therefore satisfied its responsibility to explain its change of policy. Cf. *Atchison T. &*

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[9] Petitioners contend (Pet. 17) that the Commission had taken the position in its decisions in *Ex Parte No. 338* and *Ex Parte No. 353* that 49 U.S.C. (Supp. IV) 10704(a)(2) prohibited the Commission from adopting a single standard of revenue adequacy and that the Commission therefore erred in not explaining why its legal position on this question of statutory construction had changed. However, as a reference to the pages of the Commission's decisions relied upon by petitioners makes clear, the Commission did not rest its decisions on a conclusion that the statute precluded it from settling on one measure of revenue adequacy; it simply described why it determined that consideration of other factors was appropriate. See 358 I.C.C. at 858-859; 362 I.C.C. at 216. The Notice of Proposed Rulemaking in *Ex Parte No. 338* did state that what is now Section 10704(a)(2) does not envision that rate of return will be the sole factor to be considered in judging revenue adequacy. See 358 I.C.C. at 904. But the Commission did not take a contrary view here; it considered the other statutory factors and determined that they would be satisfied by using rate of return as a measure of the revenues that would be necessary to accomplish the statutory purpose.

S.F. R. v. *Wichita Board of Trade*, 412 U.S. 800, 808-809 (1973) (plurality opinion of Marshall, J.).

3. Petitioners object (Pet. 19-20) because the Commission included "unused and non-useful" assets in the net investment base. This objection is insubstantial, especially in this case. Throughout these proceedings the Commission actually has agreed that it should seek to eliminate unused and unuseful assets from the investment base when it is feasible to do so. But the Commission also recognized that the identification of unused and unuseful assets is a complex and controversial task that could not be performed within the 180-day period allowed by Congress for completion of the initial revenue adequacy determination (*ibid.*). Further, the Commission found that including unused and unuseful assets in the initial investment base would cause only a "minor distortion," because these assets amount to significantly less than 1% of total net investment [10] and because the railroads with the highest percentage of unused and unuseful assets are the least profitable and therefore are the least likely to be found revenue adequate in any event (*id.* at 10b). The court of appeals found evidence in the record to support these findings, and on this basis correctly concluded that "no adjustment to the book values of the investment base [to reflect unused and unuseful assets] was necessary at this

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[10] Petitioners attempt to show the significance of this issue by referring (Pet. 20 n.14) to a railroad witness' estimate that there are $225 million in unused and unuseful property. This figure was derived using the generous and questionable assumption that the book value per mile of unuseful property is equal to the average book value per mile of all railroad property. Even so, this estimated total amounted to only .79% of railroad net investment.

time, because no likelihood of substantial over-valuation was established" (*id.* at 31a).

This issue may soon be mooted in any event, because the Commission recently proposed a number of substantial changes to improve the accuracy of its initial revenue adequacy standards. One of these proposals is "Elimination of Assets that are not used and useful from the investment base." *Ex Parte No. 393 (Sub-No. 1), Standard for Railroad Revenue Adequacy* (Mar. 9, 1983), slip op. 2. In these circumstances, the Commission's inclusion of these assets presents no issue warranting this Court's review.

4. Petitioners attack (Pet. at 20-21) the Commission's decision to use the current cost of debt, rather than the embedded cost of debt, in computing the adequate rate of return on carrier net investment. Petitioners claim that the Commission's approach overstates debt costs because, at the present time, the current cost of debt substantially exceeds the carrier's contractual interest and principal repayment requirements.

Contrary to the premises underlying petitioners' contention, however, "revenue adequacy" for purposes of 49 U.S.C. (Supp. IV) 10704(a) is a long-run and forward-looking concept. The Commission must establish revenue levels adequate to "attract and retain capital in amounts adequate to provide a sound transportation system" in the future (49 U.S.C. (Supp. IV) 10704(a)(2)(B)), rather than merely measure the historical profitability of a carrier or that carrier's ability to repay the debt associated with past investments. Moreover, as the Commission found (Pet. App. 13b), if a railroad attempts to raise capital today, either to rebuild worn-out facilities or to expand existing facilities, it must compete for scarce investment funds. To do so, it must offer a rate of

return equal to the cost of capital, where the cost of capital is the weighted average of the current cost of debt and the current cost of equity capital. Conversely, and as noted by the court of appeals, "[i]f the railroads could not gain a rate of return on investment represented by old debt in excess of the old interest rates on such debt, they would be unlikely to attract new equity capital, and their shareholders would insist on investment of internally generated funds outside the rail industry" (*id.* at 28a).

The Commission's choice of the current cost of capital also cannot be divorced from its choice of an original cost investment base or its obligation to promulgate standards that "cover the effects of inflation." 49 U.S.C. (Supp. IV) 10704(a)(2)(A). The Commission was aware that the current and embedded cost of debt differ largely because the inflation rates anticipated by current and past investors differ.[11] Similarly, the Commission was aware that, in times of inflation, historical cost accounting systems using actual "embedded" costs fail to reflect the impact of changing prices on asset values and expenses. As a result, such systems tend to understate operating expenses (especially depreciation) and result in the reporting of illusory profits.[12] In the instant proceeding,

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[11] "The nominal cost of capital is the sum of the real cost of capital and the expected rate of inflation" (Pet. App. 12b).

[12] The Commission recently elaborated:

> Historical cost depreciation is viewed as a systematic method for allocating asset costs over useful lives. However, during periods of inflation, this cost does not reflect the economic cost consumed. Thus, while reported earnings of a company often increase during periods of inflation, the increases are not necessarily real. To maintain operating capability, for example, a railroad must

the Commission was forced to use an original cost valuation of the investment base because replacement data were unavailable (Pet. App. 17b). The Commission then selected the current nominal cost of capital as the proper rate of return standard, noting wide acceptance for the proposition that "the nominal cost of capital must be applied to an original cost-based asset valuation if the railroads are to be compensated for inflation" (*id.* at 12b); see *Ex Parte No. 393* (Notice), 45 Fed. Reg. 80152 (1980). This was a rational response to the general problem of properly accounting for inflation.[13]

5. Finally, petitioners argue (Pet. 22-24) that the Commission should have excluded deferred taxes from the railroad's net investment base and that the court of appeals created a conflict among the circuits when it affirmed the Commission's treatment of deferred taxes.

Contrary to petitioners' contention, however, there is no conflict among the circuits regarding the validity of the Commission's current position. Each of the

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> continually replace productive assets at present costs. In periods of inflation, each replacement of an asset is more costly than its predecessor. Business continuity is not assured, therefore, merely because current revenues exceed past costs. While sales, earnings and dividends increase during inflationary periods, those increases do not necessarily represent gains in net worth in real terms.

Ex Parte No. 393 (Sub-No. 1) (Mar. 9, 1983), slip op. 7 (footnote omitted).

[13] The Commission reopened the entire issue of inflation accounting, including the choice of cost of capital and investment base, in *Ex Parte No. 393 (Sub-No. 1), supra.* The Commission there proposed to withdraw the standards now under review and to replace them with a current cost valuation of the railroads' investment base and a "real" (adjusted for inflation) cost of capital rate of return.

three cases cited by petitioners [14] arose at a time when the Commission's revenue adequacy policy, as expressed in *Ex Parte No. 338*, *supra*, 358 I.C.C. at 889-894, required deduction of the deferred tax account from the net investment base. In each of the cited cases, the Commission apparently had failed to follow its own policy, and the courts simply remanded the cases to the Commission to "clarify whether this [deferred tax] adjustment was indeed appropriate and in fact performed." See, *e.g.*, *Cleveland-Cliffs Iron Co.* v. *ICC*, 664 F.2d 568, 586 (1981).[15] In a notice issued in *Ex Parte No. 347 (Sub-No. 1)*, *Coal Rate Guidelines—Nationwide*, 364 I.C.C. 360, 371 (1980), however, the Commission suggested that its *Ex Parte No. 338* policy should be changed, because it substantially reduced the incentive of railroads to undertake railroad investments, and thus thwarted "the intent of Congress in passing the Revenue Acts of 1954 and 1962, to provide business enterprise with tax benefits as a means of spurring capital spending."

The Commission adopted this reasoning in the instant proceeding, finding that "[i]f we exclude in-

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[14] *San Antonio* v. *United States*, *supra*, 631 F.2d at 847; *Iowa Public Service Co.* v. *ICC*, 643 F.2d 542, 546-547 (8th Cir. 1981); and *Cleveland-Cliffs Iron Co.* v. *ICC*, 664 F.2d 568, 586 (6th Cir. 1981).

[15] In *San Antonio* v. *United States*, the court of appeals expressed the view that under principles expressed in certain public utility rate cases, the deferred tax account should be deducted from the net investment base once normalization of taxes is elected. 631 F.2d at 847. As the court itself noted (*ibid.*), however, the Commission's policy at that time was to deduct deferred taxes, and the Commission had simply failed to follow that policy in the case under review. The D.C. court therefore had no occasion to review the Commission's revised policy, at issue in this case.

ternally generated funds, whether stemming from accelerated depreciation or any other railroad activity, from the investment base, the effect will be to establish a rate of return below the cost of capital" and "result in incentives to railroads to invest these funds in nonrail operations" (Pet. App. 11b). Against this background, the Commission adopted its new policy of including deferred taxes in the net investment base, accompanied by a careful explanation of its change from the prior policy.[16] The court of appeals correctly recognized that the cases decided under the Commission's old policy no longer apply (Pet. App. 33a & n.8), and found the Commission's new policy "rationally supported" and "consistent with the Congressional directive" (*ibid.*). The court of appeals' decision affirming the Commission's treatment of the deferred tax acount—the first decision addressing the Commission's new policy—does not warrant review by this Court.[17]

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[16] Petitioners claim the Commission's treatment of deferred taxes is inequitable because it permits the railroads to earn a return on investment capital "provided by the ratepayers" (Pet. 24) and not by railroad investors. The deferred tax account is not contributed by the ratepayers, however; if contributed by anyone, it is by the federal government, through authorization of accelerated depreciation for tax purposes. The Commission determined that its treatment of deferred taxes was consistent with the congressional purpose underlying accelerated depreciation of encouraging capital spending—a policy that also is consistent with the goals of the 4R and Staggers Acts.

[17] The Commission is again considering how tax benefits should be treated in computing revenue adequacy in order to reflect the impact of the Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, 95 Stat. 172. See *Ex Parte 393 (Sub-No. 1)*, *supra*, slip op. 13.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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